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No. 17

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

UNITED STATES OF AMERICA, *Petitioner*

v.

THE DONRUSS COMPANY, *Respondent*

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT

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OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (Record at 50-60) is reported at 384 F.2d 292.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1967 (Record at 3, 61). The petition for a writ of certiorari was filed on December 26, 1967, and was

granted on April 22, 1968 (Record at 62). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a corporation which accumulates earnings beyond the definite and certain needs of its business will be subject to a penalty tax on those earnings imposed under Section 531 of the Internal Revenue Code of 1954, unless it is able to demonstrate by the preponderance of the evidence that no consideration was given to the tax result a distribution of those earnings would produce to the shareholders if passed to them as dividends.

STATUTE INVOLVED

Internal Revenue Code of 1954:

> Sec. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.
>
> In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—
>
> (1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus
>
> (2) 38½ percent of the accumulated taxable income in excess of $100,000.
>
> [26 U.S.C. 531]
>
> Sec. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX
>
> (a) *General Rule.* —The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.
>
> [26 U.S.C. 532(a)]

Sec. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

[26 U.S.C. 533(a)]

Sec. 535. ACCUMULATED TAXABLE INCOME

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(c) *Accumulated Earnings Credit.*—

(1) *General Rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum Credit.*—The Credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

[26 U.S.C. 535(a), (c)(1), (2)]

STATEMENT

Respondent is a corporation which, during the taxable years 1960 and 1961, was engaged in the manufacture and sale of confectionery products and in addition operated a farm. Since 1954 all of respondent's outstanding stock has been owned by Donald B. Wiener. Record at 17. The farming operation conducted by respondent was initiated during the 1930's in connection with the manufacture and sale of pickles. At that time neither Mr. Wiener nor his then partner could afford to purchase a farm, so rented farm properties were utilized. Transcript at 53-4. In 1947 respondent entered into the confection business, manufacturing bubble gum and candy. *Id.*

Since its formation, respondent has been generally successful, and as petitioner notes, during the period 1955 through 1961 its earned surplus increased from $1,021,288.58 to $1,679,315.37. On the other hand, during the period 1949 through 1964 respondent's earned surplus increased by less than 50 percent. Record at 15; defendant's Exhibit 49. Respondent had net quick assets during the years 1960 and 1961 of $848,659.54 and $926,612.24, a ratio of current assets to current liabilities of 8.3 to 1 and 14.9 to 1, respectively. In 1962 this ratio increased to 27.9 to 1. However, in 1963 and 1964 the ratio declined to 7.4 to 1 and 4.8 to 1. Record at 13; defendant's Exhibit 48. While these figures indicate substantial liquid assets, respondent's ratio of net quick assets to monthly sales, the true indicator in the industry, Transcript 144-45, was considerably less than that of other gum manufacturers. While respondent enjoyed substantial annual profits from 1949 through 1964, its net quick assets, that is, assets which have not been invested in fixed assets of the business, have not substantially increased during that period. Record at 13; defendant's Exhibit 48.

During the years at issue, respondent made no loans to Mr. Wiener or his relatives, nor did it afford them luxuries, or make investments unrelated to its business.

Transcript at 483-84. Mr. Wiener testified that the company's policy of not paying dividends and of reinvesting its earnings in the business, was motivated, *inter alia*, by the recurring need for new plant and equipment; increasing wages; the inherent risk and competition in the bubble gum business; and the consequent need for diversification and expansion; and finally, the necessity of purchasing large amounts of inventory, especially sugar, as a hedge against shortages. Transcript at 48-65.

Influential also was respondent's desire to make a substantial investment in the Tom Huston Peanut Company. Although during the years at issue taxpayer admittedly had no fixed or definite plans to buy a particular number of shares at a particular price, it is clear that since 1949 Mr. Wiener had expressed on numerous occasions a desire to make a substantial investment in the Tom Huston Peanut Company.[1] Transcript at 81-86; 354-364. Such an investment was deemed necessary because 50 percent of respondent's sales were made to distributors which, although nominally independent, were in fact controlled by the Tom Huston Peanut Company. Transcript at 110-111, 119-20. Thus, in 1964 taxpayer purchased 10,000 shares of Tom Huston stock at a cost of $380,000, which at the time made respondent between the 10th and 20th largest shareholder in that company. Transcript at 114, 177.

The Commissioner of Internal Revenue assessed and collected from respondent accumulated earnings taxes for the taxable years 1960 and 1961. Thereafter, respondent brought an action for the refund of said taxes in the United States District Court for the Western District of Tennessee. On the basis of the jury's finding that respondent had not

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[1] Petitioner's assertion that respondent's Treasurer first learned of plans to acquire Tom Huston stock in 1963, Brief for Petitioner at 4, n.4, is misleading. Admittedly there were no definite plans to acquire stock prior to that time, but the Treasurer's testimony indicates clearly that he knew of respondent's desire to purchase such stock for at least 10 years prior to that time. Transcript at 354-364.

accumulated its earnings for the purpose of avoiding tax on its shareholders, the district court entered judgment for respondent. The United States appealed to the Court of Appeals for the Sixth Circuit which reversed on the ground that the district court erred in failing to explain the significance of the phrase "the purpose" when it instructed the jury that the avoidance of taxes on the corporation's shareholder had to be "the purpose" for the accumulation of earnings. Rejecting petitioner's contention that the jury should be instructed that tax avoidance need be only "one of the purposes" for the company's accumulation policy, the court of appeals held that on remand the jury should be instructed that in order for the accumulated earnings tax imposed by Section 531[2] to apply, taxpayer must demonstrate that tax avoidance was not the "dominant, controlling or impelling motive" behind an accumulation of earnings in excess of objectively reasonable business needs.

SUMMARY OF ARGUMENT

Although Section 531 and its predecessors have imposed a tax upon accumulated earnings since the first federal income tax was enacted, and although the phrase "availed of for the purpose" has remained unchanged for these fifty-five years, beginning in 1942 six circuit courts of appeal have evolved three different standards for its application. The Second and Fifth Circuits have held that taxpayer must prove the absence of "any" tax saving motive, without analysis of the causal relationship of such a motive to the accumulation of earnings; the Eighth and Tenth Circuits have held that taxpayer must prove that tax saving was not a "determinating" or "determining" motive for the accumulation; the First and Sixth Circuits, on the other hand, have held that taxpayer must demonstrate that tax saving was not the primary, dominant, controlling or impelling motive for an accumulation of earnings.

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[2]Unless otherwise indicated, references are to the Internal Revenue Code of 1954.

As a practical matter, whenever a closely held corporation accumulates earnings, tax minimization is a known consequence. In petitioner's view this fact of every day life is sufficient to trigger the penalty tax, which would thus apply to every accumulation beyond what are, when viewed with twenty-twenty hindsight, objectively reasonable business needs. The effect of this argument is to eliminate from consideration the subjective elements which, under Section 532(a) must be present prior to the imposition of the surtax.

The standard adopted by the First and Sixth Circuits, unlike that advanced by petitioner, is directed toward the motivating consideration behind taxpayer's conduct. Such an approach is supported by analogy to other areas of the tax law where intent is the ultimate issue and where the statute is silent as to the degree or significance of the motivation. Also, the First and Sixth Circuits' test is most compatible with the competing economic policies involved in the application of the accumulated earnings tax and, in addition, is supported by the statute and is consistent with the legislative history. Finally, the decision of the court below is supported by this Court's opinion in *Helvering v. Chicago Stock Yards Co.*, 318 U.S. 693 (1943), wherein the Court recognized that the relationship between tax saving motives and a decision to accumulate is part of the inquiry under Section 531.

ARGUMENT

THE ACCUMULATED EARNINGS TAX IS APPLICABLE TO UNREASONABLE ACCUMULATIONS OF CORPORATE EARNINGS, UNLESS THE TAXPAYER ESTABLISHES TO THE SATISFACTION OF THE TRIER OF FACT THAT THE DOMINANT, CONTROLLING OR IMPELLING MOTIVE BEHIND THE ACCUMULATION WAS NOT THE AVOIDANCE OF FEDERAL INCOME TAXES WITH RESPECT TO ITS SHAREHOLDERS.

A. THE STATUTORY PATTERN AND EVOLUTION OF THE SECTION 531 TAX

Under Sections 531 and 532(a), a corporation which accumulates its earnings beyond the reasonable needs of its business will be subject to a substantial penalty tax on that portion of its earnings so accumulated provided the corporation was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders." The statute thus establishes both objective and subjective criteria to test the application of the penalty tax. To the extent that the taxable year's earnings are reasonably required to defray needs for which the taxpayer has specific, definite and feasible plans, susceptible of objective verification, Treas. Reg. § 1.537-1(a), (b) (1960), then to that extent the accumulation will not be subject to the penalty tax, notwithstanding that it may have been prompted solely by tax avoidance motives. *See John P. Scripps Newspapers, Inc.*, 44 T.C. 453 (1965); INT. REV. CODE OF 1954 § 535 (c)(1). *But see, Carolina Rubber Hose Co.*, 24 CCH Tax Ct. Mem. 1159 (1965). However, if the accumulation is found to be in excess of such needs, then to the extent of this excess, such finding is *determinative* of the purpose to avoid the income tax with respect to the corporation's shareholders unless the taxpayer can prove by the preponderance of the evidence to the contrary. INT. REV. CODE OF 1954 § 533(a). Thus, while the ultimate and fundamental area of conflict remains the subjective criteria of intent under the 1954

Code, the war has been waged over the more objective element of business needs owing to the fact that few taxpayers are either prepared or able to satisfy the burden of proof imposed by the statute. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 219-20, 233 (2d ed. 1966).

A tax similar to the one now imposed by Sections 531-537 has played a part in the drama of American business for more than fifty years. The Revenue and Tariff Act of 1913[3] provided that in addition to other taxes, a shareholder would be taxed on his pro rata share of the earnings of a corporation "formed or fraudulently availed of for the purpose of preventing tax on the shareholders." The fact that the corporation was a mere holding company or that earnings were permitted to accumulate beyond the reasonable needs of the business was "prima facie evidence" of a purpose to escape such tax. The Revenue Act of 1916[4] made no material change in the provision. However, the Revenue Act of 1918[5] deleted the word "fraudulently" from the statute. This change was made because of the difficulty in proving fraud.[6]

The decision of this court in *Eisner v. Macomber*, 252 U.S. 189 (1920) prompted Congress in 1921 to impose the tax directly upon the corporation instead of the shareholders. *United Business Corp. v. Commissioner*, 62 F.2d 754, 756 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933); H. R. REP. No. 350, 67th Cong., 1st Sess. 12 (1921). However, the basic pattern of previous acts was continued in that an accumulation beyond reasonable business needs, while prima facie evidence of a tax avoidance purpose,[7] did not automatically

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[3]Ch. 16, § II(a)(2), 38 Stat. 114 (1913).

[4]Ch. 463, § 3, 39 Stat. 758 (1916).

[5]Ch. 18, § 220, 40 Stat. 1057 (1919).

[6]*See* S. REP. NO. 617, 65th Cong., 3d Sess. 5 (1918); 57 Cong. Rec. 253 (1918).

[7]Revenue Act of 1921, § 220, 42 Stat. 247.

trigger the penalty tax since the statute required that "the" purpose of the accumulation must be tax avoidance, thereby permitting taxpayer to introduce other purposes which, if persuasive to the trier of fact, would negate the prima facie case established by the statute. Although an attempt was made in 1928 to enact a mandatory imposition of the surtax whenever undistributed profits exceeded thirty percent of a corporation's net income, dividends and tax-free interest,[8] and although the difficulty of proving the specific purpose for the accumulation had rendered the provision more or less ineffective,[9] it continued substantially unchanged until 1938.[10]

In 1938, Congress became concerned with the difficulties encountered by the Commissioner in connection with proof of the element of intent to avoid tax.[11] These difficulties were highlighted by two decisions, *National Grocery Co. v. Helvering*, 92 F.2d 931 (3rd Cir. 1937) and *Commissioner v. Cecil B. DeMille Prods., Inc.*, 90 F.2d 12 (9th Cir. 1937), in which the taxpayers avoided application of the tax by minimal showings of non-tax purposes. Section 102 of the Revenue Act of 1938[12] was an attempt to remedy this situation. It continued the "prima facie evidence of a purpose" test with respect to holding or investment companies,[13] but made an accumulation beyond reasonable busi-

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[8] *See* 69 Cong. Rec. 519, 7977 (1928).

[9] H. R. REP. NO. 2475, 74th Cong. 2d Sess. 5 (1936). In fact, the statute was virtually unused until after 1930. Canty, *The Accumulated Earnings Tax 1954 Reform, An Appraisal*, 2 U. SAN FR. L. REV. 242 (1968).

[10] *See* Revenue Act of 1924, § 220, 43 Stat. 277; Revenue Act of 1926, § 220, 44 Stat. 34; Revenue Act of 1928, § 104, 45 Stat. 814; Revenue Act of 1932, § 104, 47 Stat. 195; Revenue Act of 1934, § 102, 48 Stat. 702; Revenue Act of 1936, § 102, 49 Stat. 1676.

[11] *See* H. R. REP. NO. 1860, 75th Cong., 3d Sess. 20 (1938).

[12] 52 Stat. 483.

[13] The application of the accumulated earnings tax to holding and investment companies had been rendered academic, at least with

ness needs "determinative of the purpose" to avoid the surtax upon its shareholders unless the corporation by the clear preponderance of the evidence proved to the contrary.[14] In considering the problems of implementation faced by the Commissioner, Congress did not amend the statute to require the tax to apply in those situations where a corporation was formed or availed of for "a" purpose to avoid tax. Rather, it chose to strengthen the presumption created by an unreasonable accumulation by making such a finding "determinative" of the forbidden purpose, and accordingly, the tax applied unless the taxpayer could demonstrate by a preponderance of the evidence that such accumulation was not for "the" purpose of tax avoidance.

Although there were efforts to limit the impact of Section 102,[15] no such changes were effected from 1939 to 1954, and during this period enforcement of the penalty tax provisions was considerably heightened.[16] As a result of the government's vigorous enforcement of these provisions and the success achieved, Congress received numerous complaints to the effect that Section 102 was prejudicial to small business; that it was applied in an arbitrary manner in many cases and was used by revenue agents as a threat to induce settlement on other issues. As a result, Section 102 was considered by many as a constant threat to expanding busi-

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respect to "incorporated pocketbooks," by passage of the personal holding company tax in 1934. *See* S. REP. NO. 1567, 75th Cong., 3d Sess. 4 (1938).

[14] On February 10, 1939, this provision was adopted as Section 102 of the Internal Revenue Code of 1939, 53 Stat. 35 (1939).

[15] *See* H. R. 6712, 80th Cong., 2d Sess. (1948); H. R. 961, 80th Cong., 1st Sess. (1948).

[16] During the period 1939-52, there were 68 reported cases under Section 102. JOINT COMMITTEE ON THE ECONOMIC REPORT, THE TAXATION OF CORPORATE SURPLUS, 82nd Cong., 2d Sess. 5 (1952) (hereinafter "JOINT COMMITTEE"). *See also Id.* at 109.

ness enterprises.[17] The 1954 Code thus contained various provisions to ameliorate the application of the penalty tax, including, under certain circumstances, a shift in the burden of proof as to the grounds for the accumulation from the taxpayer to the Commissioner;[18] elimination of the so-called "immediacy test" for business needs;[19] and the adoption of an accumulated earnings credit which limited the tax's application to accumulated earnings in excess of $60,000 (now $100,000), or the reasonable needs of the business, whichever was greater.[20] The 1954 amendments did not, however, eliminate the opportunity previously afforded the taxpayer, difficult as it was, to negate the determination that an objectively unreasonable accumulation of earnings was made for the prohibited purpose.

B. JUDICIAL ANALYSIS OF THE PHRASE "THE PURPOSE" AS IT APPEARS IN SECTION 532(a)

The meaning of the term "the purpose" appearing in Section 532 was first considered by an appellate court in *Chicago Stock Yards Co. v. Commissioner*, 129 F.2d 937 (1st Cir. 1942), *rev'd on other grounds*, 318 U.S. 693 (1943). Although the issue was not squarely presented, the court rejected the dictum enunciated in *R.L. Baffer Co.*, 37 BTA 851, 856, *aff'd*, 103 F.2d 487 (5th Cir.), *cert. denied*, 308 U.S. 576 (1938), wherein the Board of Tax Appeals stated that in order to escape the penalty, taxpayer must demonstrate that its purpose for the accumulation was "wholly other" than tax saving. Instead, the First Circuit adopted the position that the forbidden motive must have played a substantial part in inducing the accumulation. Sub-

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[17] S. REP. NO. 1622, 83rd Cong., 2d Sess. 68 (1954); H. R. REP. NO. 1337, 83rd Cong., 2d Sess. at 51-52 (1954).

[18] INT. REV. CODE OF 1954, § 534.

[19] INT. REV. CODE OF 1954, § 537.

[20] INT. REV. CODE OF 1954, § 535.

sequently, in *Young Motor Co. v. Commissioner*, 281 F.2d 488 (1st Cir. 1960), the First Circuit refined its position in *Chicago Stock Yards Co.*, and held that for the tax to apply, tax avoidance must be the primary or dominant purpose leading to the decision to accumulate earnings.

The next appellate court to consider the issue was the Second Circuit in *Trico Prods. Corp. v. Commissioner*, 137 F.2d 424 (2d Cir.), *cert. denied*, 329 U.S. 799 (1943). In this case, the Board of Tax Appeals held that taxpayer must carry the burden of proving the complete absence of a tax avoidance motive. *See Trico Prods. Corp.*, 46 BTA 346, 374 (1942). Without attempting to analyze the issue, the Second Circuit affirmed on the basis of a quotation from this Court's opinion in *Helvering v. Chicago Stock Yards Co., supra.*[21]

The Tenth Circuit in *World Publishing Co. v. United States*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949), and the Eighth Circuit in *Kerr-Cochran, Inc. v. Commissioner*, 253 F.2d 121 (8th Cir. 1958), although relying on the Second Circuit's opinion in *Trico Prods. Corp.*, adopted a construction which appears to differ from that of both the First and Second Circuits. *See Canty, supra* n.9, at 250-51. These courts held that taxpayers must demonstrate that the purpose to avoid taxes is not one of the "determinating" (Eighth Circuit) or "determining" (Tenth Circuit) purposes. *See also, E-Z Sew Enterprises, Inc. v. United States*, 260 F. Supp. 100, 120 (E.D. Mich. 1966).

In *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962), the Fifth Circuit, in adopting the theory previously enunciated by the Tax Court and the Second Circuit, made the first analytical attempt to justify the "any purpose" test. The court mistakenly reasoned that the utility of the presumption arising from the accumulation of earnings beyond the objectively reasonable needs of the business would be destroyed if

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[21] See note 24, *infra*.

"saddled with requirement of proof of the 'primary or dominant purpose' of the accumulation." 294 F.2d at 82. Finally, in the instant case, the Sixth Circuit adopted the basic position taken by the First Circuit in *World Publishing Co.*, and held that in order to avoid the penalty of Section 531, the taxpayer must demonstrate that tax saving was not the dominant, controlling or impelling motive behind its accumulation of earnings.[22]

C. THE "ANY PURPOSE" TEST IS INCONSISTENT WITH THE DECISIONS OF THIS COURT, AND THE STATUTE AND IMPLEMENTING REGULATIONS, AND IS NOT SUPPORTED BY THE LEGISLATIVE HISTORY

1. The issue before this Court is whether, and if so, to what extent, a tax-saving motive must influence or induce the failure to distribute earnings in excess of objectively reasonable business needs before the penalty tax of Section 531 can be applied. Put in terms of statutory context, this Court must decide whether a taxpayer, in order to prevent application of the penalty tax, must demonstrate that tax saving considerations did not play a substantial, significant or controlling role in influencing an excess accumulation of earnings or whether taxpayer must demonstrate the complete absence of tax saving considerations in its decision to accumulate.

The position of petitioner herein is that, assuming a taxpayer has one hundred[23] valid reasons or purposes for accumulating its earnings beyond its objective business needs, then notwithstanding these reasons or purposes, if the corporate managers also desired to minimize tax at the shareholder level, the statute is satisfied and the penalty tax applies without any consideration of the extent, if any, to which this desire to minimize tax influenced the final

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[22] Petitioner's suggestion that for seventeen years after this Court's decision in *Chicago Stock Yards Co.*, the law in this area was clearly settled in its favor, Brief for Petitioner at 26, is erroneous. *See* TAX INSTITUTE, ECONOMIC EFFECTS OF SECTION 102, 201 (1951).

[23] Record at 47.

decision to accumulate rather than distribute. Such a position, while apparently adopted by the Tax Court and the Second and Fifth Circuits, is inconsistent with the Court's opinion in *Helvering v. Chicago Stock Yards Co.*, *supra*. Although the Court did not squarely address itself to this issue,[24] it did note that a subsequent tax saving motive may "induce or aid in inducing" the continuation of a practice theretofore adopted solely for non-tax reasons. Thus, the Court recognized that for the tax to apply, there must be a causal relationship between the tax saving motive and the decision to accumulate.[25] The rationale of the

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[24] In this case, Mr. Justice Roberts noted that

> A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice.

318 U.S. at 699. As the court below noted,

> It would greatly strain the court's remarks to conclude that on so employing the parenthetical phrase "or aided in inducing," it was considering the important question here posed, that is to say, whether the purpose to avoid income tax need be the dominant, controlling or impelling purpose.

Record at 58; *Accord*, Canty, *supra*, n. 9, at 250. In *Chicago Stock Yards Co.*, the Board of Tax Appeals found that the sole purpose of the company's retention of earnings was tax avoidance. 41 BTA 621. In this Court, the central issue was the sufficiency of the evidence to sustain the Board's finding. The other issue, in connection with which the cited language was used, was whether what was originally a non-tax arrangement could be turned into a tax-avoidance device.

In connection with the passage from *Chicago Stock Yards Co.*, quoted above, petitioner asserts at pages 25-26 of its brief that the application of the Section 531 tax does not depend upon a significant change in corporate practices. *But see United Business Corp.*, 19 BTA 809, 828 (1930), *aff'd*, 62 F.2d 754 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933).

[25] *See also* B. BITTKER & J. EUSTICE, *supra* at 216.

Court's decision thus clearly supports both in principle and logic the decision of the Sixth Circuit and, contrary to petitioner's plea, does not support the "any" purpose test.

Petitioner's refusal to weigh the influence of tax minimization upon the decision to accumulate appears all the more unwarranted if calculations showing how much tax was saved to the shareholder are considered as evidence of purpose. Under petitioner's proposal, the penalty tax would apply even if the tax saving to the shareholders was de minimis and the purpose to effect such saving was insignificant in comparison with other reasons for the accumulation.

Moreover, it is an accepted principle of tax law that an otherwise bona fide transaction will not be tainted merely because of a subsidiary tax saving purpose. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Goldstein v. Commissioner*, 364 F.2d 734, 741 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); *see Commissioner v. Brown*, 380 U.S. 563 (1965). Consequently, the mere presence of a tax saving purpose should not precipitate application of the Section 531 tax without any analysis of its relationship to the accumulation.

2. In a curious play on words with a view to avoiding any meaningful construction of the statute, petitioner suggests that since every corporation is formed or availed of for multiple corporate purposes and since tax saving is invariably one of the considerations involved in the utilization of a corporation, the statutory purpose is automatically satisfied in those situations where a corporation accumulates earnings beyond the objectively reasonable needs of the business. Brief for Petitioner at 11-13. Under petitioner's theory, every corporation is availed of for tax avoidance purposes, and accordingly, the only inquiry which need be made is whether or not an accumulation exceeds the objectively reasonable needs of the business. If an accumulation is in excess of this standard, then no further inquiry need be made and the tax applies. This simplistic approach results not in a "construction" of the statute but rather the

elimination of that portion of the statute which requires the accumulation to be motivated by tax avoidance purposes prior to the application of the penalty tax.

It is axiomatic that operating a profitable business in corporate form inherently permits the retention of all or a portion of the corporation's earnings. Whether the interposition of a corporate entity will result in greater or lesser tax to the Treasury depends on numerous factors including the rates of tax on corporations and individuals and the deductions available in any given year to either the corporation or individual. Undoubtedly, in organizing a corporation, the owners or business managers recognize that tax benefits may necessarily flow therefrom, especially in those situations where the individual taxpayer's bracket is greater than that of the corporation. Normally, however, a multitude of factors unrelated to tax consequences motivates the use of the corporate entity, *e.g.*, insulation of the owner against tort liability; protecting the owner's other assets from the risk of the business conducted by the corporation; permitting more efficient and centralized operation of the business; permitting the corporation to take advantage of the various pension, profit sharing and stock option provisions of the Internal Revenue Code of 1954, as amended; facilitating financing arrangements; and permitting a more orderly disposition of the business through gifts and transfers of stock.

The fact that tax savings is one of the purposes in causing individuals to utilize the corporate entity has never caused the corporation to be ignored for tax purposes or tainted the corporation for purposes of applying the various provisions of the Internal Revenue Code. Carried to its logical conclusion, petitioner's view would demand that every corporation be tainted for purposes of the unreasonable accumulation provisions since by its very nature it is formed or availed of for tax savings. Consequently, every accumulation in excess of the objectively reasonable needs of the business would be subject to the penalty.

The officers and directors of a closely held corporation[26] can be presumed to know the resulting tax consequences to themselves or, if they are not in control, to the controlling shareholders if earnings are distributed as dividends: absent offsetting deductions, income tax will be payable. Certainly, if a taxpayer understands the tax laws, it seems only reasonable that tax minimization will occupy some of his thinking. As the First Circuit noted in *Young Motor Co.*, to the extent that tax savings are a necessary result of an accumulation, they are a contemplated consequence thereof.[27] Thus, as a practical matter, under petitioner's theory, knowledge of the tax benefits to be derived would be sufficient to carry the day.[28] Obviously, this is not the purpose at which the statute was directed.

By seeking to prevent consideration of the relationship between tax saving motives and the decision to accumulate earnings, petitioner attempts to limit the scope of the inquiry in applying the Section 531 tax to the objectively reasonable needs of a corporation's business. In support of its position, petitioner argues that once it is shown that earnings have been accumulated beyond the reasonable needs of the business, there is no credible objective evidence of proper motives.[29] However, Congress has previously considered and

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[26] As a general rule, the tax is imposed only on closely held corporations. *See* H. R. REP. NO. 1337, *supra* n. 17, at 54. Although in *Trico Prods. Corp.*, *supra*, there were 2,000 shareholders, 70 percent of the stock was owned by a small group.

[27] 281 F.2d at 491.

[28] *See Id.*; Record at 46-47.

[29] *See* Brief for Petitioner at 18-21. This argument, however, confuses objective evidence with objectively definite and fixed business needs of the variety for which a credit can be obtained under Section 535. Obviously, taxpayer's reasons for an accumulation of earnings beyond what is needed in its business would have to be established to the satisfaction of the trier of fact. *See, e.g., Bremerton Sun Publ. Co.*, 44 T.C. 566 (1965).

rejected a wholly objective approach[30] and while the 1954 amendments have reduced the significance of the subjective factors, these amendments were intended to benefit the taxpayer in facing the threat of the penalty tax, not to prejudice him as petitioner implies.

Furthermore, the Treasury's own regulations require that such an inquiry be made. Thus, Section 1.533-1(a)(2) provides that the existence or non-existence of the purpose to avoid income tax with respect to shareholders depends upon the particular circumstances of each case, including dealings between the corporation and its shareholders, the investment by the corporation in assets having no reasonable connection with the business of the corporation, and the dividend policy of the corporation. The purpose of the regulations is to set forth certain criteria with a view to establishing the principal and dominating motives of the taxpayer. Thus, assuming the absence of corporate loans to shareholders and unrelated corporate investments and a reasonable dividend policy, the obvious inference to be drawn is that the conduct of the taxpayer in withholding earnings was not principally motivated by tax avoidance purposes. Accordingly, the regulatory scheme seeks to determine the dominant and controlling factors of behavior by requiring an analysis of multiple transactions, any one of which may be indicative of taxpayer's ultimate purpose.

The result of petitioner's per se position is to read out of the statute the phrase "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders." The insidiousness of the petitioner's position is further aggravated by the fact that the Treasury in its day-to-day application of the credit provisions of Section 535(c) has attempted to limit severely the scope and extent of taxpayer's business needs. *E.g.*, Brief for Respondent at 34-37, Reply Brief for Respondent at 11, *John P. Scripps Newspapers, Inc., supra*. As a result, the application of the Sec-

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[30] See text at footnote 8, *supra*.

tion 531 tax, at least at the revenue agent level, is determined by reference to liabilities appearing on the balance sheet and obligations under written commitments. Although some relief might be obtained on review, the cost of litigation frequently proves to be an insurmountable obstacle to the small taxpayer.[31] While there may be some merit in this procedure in terms of ease of administration, it is clearly and wholly repugnant to the statutory pattern.

For an example of the consequences flowing from the government's interpretation of the statute, the Court is respectfully referred to *The Shaw-Walker Co.*, 24 CCH Tax Ct. Mem. 1709 (1965), *rev'd*, 390 F.2d 205 (6th Cir. 1968), *petition for cert. filed*, 36 U.S.L.W. 3444 (U.S. May 13, 1968) (No. 1431, 1967 Term; renumbered No. 95, 1968 Term). In this case, the Tax Court found that the corporation did not syphon off earnings in disguised form by loaning money to or providing luxuries for its shareholders; that there were no investments in unrelated businesses; and that during the years at issue between 43.1 percent and 33.9 percent of net after tax income was distributed in dividends, which distributions were established by uncontradicted evidence to be in excess of average industry distributions. See Brief for Appellant at 65-67, *Shaw-Walker Co. v. Commissioner*, 390 F.2d 205 (6th Cir. 1968).

Although the taxpayer thus measured favorably against the most significant criteria for determining intent, as set forth in Section 1.533-1(a)(2) of the Regulations, and although taxpayer's principal witness, whom the Tax Court found to be "extremely cooperative" and a witness whose "honesty has impressed me," Record at 398a, testified that the company was not used to avoid tax and that its affairs were managed

[31] S. REP. NO. 1622, *supra* n. 17, at 70-71; H. R. REP. NO. 1337, *supra* n. 17, at 52, 54. In the instant case, respondent seeks refunds of approximately $35,000 in tax. In connection with this recovery, taxpayer has been involved in proceedings before a district court, a court of appeals and now the Supreme Court; and, notwithstanding the disposition by this Court, will again be involved in litigation in the district court.

for the sole purpose of maintaining the company as a sound going enterprise, Record at 374a, 393-95a, the Tax Court held that notwithstanding this evidence, taxpayer had not met its burden of proof on the issue of intent. In holding for the Commissioner in this case, the Tax Court relied solely upon the presumption of Section 533 and the fact that during each of the years in issue the majority shareholder was in a very high income tax bracket. In effect, the Court held that if earnings are accumulated beyond objective business needs, and if the principal shareholders are subject to a high rate of tax, the Section 531 tax applies.

3. Petitioner maintains that its position is conclusively supported by the legislative history of Sections 531-537. Initially, it notes that prior to 1938 the predecessor to Section 533(a) made an unreasonable accumulation "prima facie evidence of *a* purpose to avoid surtax," although the taxing provision was addressed to corporations "availed of for *the* purpose." Petitioner then argues that the definite article "the" could hardly have been intended to control application of the statute when the companion evidentiary section used the indefinite "a" at the parallel point.[32] Petitioner's argument, however, will not wash because it fails to recognize the significance of Congress' use of the article "a" in the evidentiary section of the statute and the article "the" in the operative part of the statute. The operative provisions provide that the penalty will only result in those situations where the corporation was availed of for the purpose of avoiding income tax with respect to its shareholders. The evidentiary portion of the statute made an unreasonable accumulation "prima facie" evidence of *a* purpose to avoid surtax upon shareholders. An unreasonable accumulation, which was deemed prima facie evidence of *a* purpose, shifted the burden to the taxpayer to show that although tax saving was a purpose for the accumulation it was not *the* purpose motivating the accumulation.

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[32] Brief for Petitioner at 16.

Accordingly, the evidentiary section of the statute required the conclusion that an excess accumulation would render the penalty applicable unless taxpayer could demonstrate some non-tax reason for its failure to distribute earnings. Once such a non-tax reason was introduced, the Commissioner's prima facie case was negated. However, if taxpayer failed to introduce evidence to counter the prima facie presumption, the inferred purpose would be deemed "the purpose" and the penalty tax would apply by virtue of taxpayer's failure of proof. This analysis of the statute is supported by the contemporaneous expression that the "prima facie evidence" provision did no more than make the taxpayer show its hand. *United States v. R. C. Tway Coal Sales Co.*, 75 F.2d 336, 337 (6th Cir. 1938); *United Business Corp. v. Commissioner, supra* at 756. Moreover, it was the inefficacy of the former provision and the ease with which the presumption could be avoided, spotlighted by *National Grocery Co., supra*, and *Cecil B. DeMille Prods., Inc., supra*, which led to the language currently found in Section 533(a).

Contrary to petitioner's argument, Congress was well aware of the distinction it was making in the statute and if it intended to adopt the "any" purpose test suggested by the petitioner, it could have simply used the article "a" instead of "the" in the operative portion of the statute. The fact that it deliberately chose not to do so is ample testimony to the fact that Congress intended "the purpose" to be the dominant, motivating and controlling reason for the accumulation for the penalty tax to apply.

Curiously, petitioner contends that the statute from the very beginning required and was uniformly interpreted as requiring only "a" purpose of tax savings on the part of the taxpayer for the statute to apply. However, the 1938 amendment did not change the operative provision of the statute, "availed of for the purpose"; it merely effected a change in the presumption. Thus, instead of an excess accumulation being "prima facie evidence" it was determinative evidence of the tax avoidance purpose. If, as peti-

tioner contends, the statutory purpose was historically satisfied by a showing of tax savings alone, notwithstanding a multitude of non-tax reasons, it is difficult to envision that a change in the presumption would cause any change in the tax result since it is the government's view that all that was required for the tax to apply was an excess accumulation coupled with knowledge of the tax savings to the shareholders as a result of the accumulation at the corporate level. The success which the government enjoyed in this area subsequent to the 1938 amendment occurred because the introduction of the determinative presumption imposed a most difficult burden on the taxpayer in its effort to show that the dominant, controlling and compelling reason for the accumulation was not for the purpose of tax avoidance, not because the statute provided that tax savings alone was sufficient to cause the surtax to apply.

In support of its legislative history argument, petitioner also cites[33] an excerpt from the Congressional reports on the Revenue Act of 1938, which described the change from "prima facie evidence" to "determinative" as

> requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon the shareholders after it has been determined that the earnings and profits have been unreasonably accumulated.[34]

This off-hand reference, however, does not indicate that Congress actually deliberated upon the significant issue presented herein, and the absence of discussion in the hearings or during floor debate confirms the view that such was not the case. The aforementioned quotation is all the more gratuitous in view of the fact that the Revenue Act of 1938 made no change in the operative taxing phrase which is be-

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[33] Brief for Petitioner at 17.

[34] H. R. REP. NO. 855, 76th Cong., 1st Sess. 6 (1939); S. REP. NO. 1567, *supra* n. 13 at 4-5.

fore the Court in this case, since Section 533(a) and its predecessors are and were merely aids to the Commissioner in proving the element of intent, enacted more than twenty years after the birth of the taxing phrase itself. As this Court has held on numerous occasions, the views of one Congress as to the construction of a statute adopted many years prior by another Congress have very little, if any, significance. *E.g., United States v. Southwestern Cable Co.*, __ U.S. __, 88 S. Ct. 1995, 2001 (1968).

In a final effort to persuade this Court that Congress intended to have the surtax apply if tax savings is one of the purposes for an accumulation beyond the objectively reasonable needs of the business, petitioner refers to Section 535(c).[35] The relevance of this section to the argument advanced by petitioner is difficult to comprehend in view of the fact that this section was intended to insulate the corporation from the surtax in circumstances where either the accumulation was not beyond the reasonable objective needs of the business but, in fact, was principally motivated for tax avoidance purposes or where the portion of an accumulation which was primarily and principally for tax avoidance, tainted the portion accumulated for objectively reasonable needs of the business.

Under the 1939 Code and previous revenue acts, the tax would be imposed where the subjective motive for an accumulation was tax savings, notwithstanding that the accumulation did not exceed the objective needs of the business. *See, e.g., United States v. R. C. Tway Coal Sales Co., supra;* Treas. Reg. 118, § 39.102-2 (1953). As the First Circuit noted in *Chicago Stock Yards Co.*, although

> the accumulation may have been within the reasonable needs of the business judged by objective standards, the other evidence might indicate that the directors, in deciding to withhold the distribution of dividends,

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[35] Brief for Petitioner at 17-18.

> were concerned not so much with providing for business needs (as to which, as a matter of judgment, they may have been in doubt), as with the desire to avoid heavy surtaxes to the shareholders.[36]

Moreover, if part of the accumulation was made for tax saving reasons, the whole accumulation was taxed, because under Section 102 of the 1939 Code, the tax was upon "undistributed Section 102 income," which included all accumulated earnings.

Apparently, petitioner reasons that since Section 535(c) was intended to eliminate the surtax to the extent that demonstrable business needs justify the accumulation without any necessity of inquiry into the subjective element for any portion of the accumulation, any accumulation beyond such needs is to be taxed under Section 531. Alternatively, petitioner suggests that "[T]he simultaneous presence of other motives at most serves to reduce the tax through application of the credit provisions of Section 535(c)." Brief for Petitioner at 10. Petitioner's analysis confuses the objective and subjective elements of Sections 531-537 and their predecessors. Initially, it must be remembered that Section 535(c) was enacted as a benefit to the closely held corporation in that it made clear that any accumulation which did not exceed the objective needs of the business would not be subject to the tax notwithstanding taxpayer's motive for this accumulation. Secondly, it provided that if a portion of the accumulation could be justified in terms of objective business needs, such portion would not be subject to the tax notwithstanding that the remainder of the accumulation was principally and dominantly motivated by tax avoidance purposes. In adopting the accumulated earnings credit of Section 535(c), Congress was interested in excluding from the application of the penalty tax those earnings not in excess of objectively reason-

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[36] 129 F.2d 950. *Accord, Young Motor Co. v. Commissioner, supra* at 491; *see R. Gsell & Co. v. Commissioner*, 294 F.2d 321 (2d Cir. 1961).

able business needs, notwithstanding the subjective motive for the accumulation and thus, eliminating both uncertainty and the necessity for a searching and costly inquiry in these situations.[37] Under no circumstances was Section 535(c) intended to, nor did it eliminate the opportunity of taxpayer to show by a preponderance of the evidence that an accumulation beyond its objective business needs was not principally motivated by tax avoidance purposes.

D. THE "DOMINANT, CONTROLLING OR IMPELLING MOTIVE" STANDARD IS CONSISTENT WITH THE STATUTORY PROVISIONS, IS SUPPORTED BY ANALOGY TO OTHER PROVISIONS WITH SIMILAR PURPOSES, AND CONSTITUTES A REASONABLE RESOLUTION OF THE CONFLICTING POLICIES AFFECTING APPLICATION OF THE SECTION 531 TAX.

Clearly, in order for the accumulated earnings tax to be applicable, the tax saving motive must have played an effective part in the decision to accumulate rather than distribute corporate earnings. If taxpayer can convince the trier of fact that earnings would have been retained even if a distribution would not have been taxable to its shareholders, the penalty tax should not apply. The question remains as to the terms in which this standard should be enunciated. It is submitted that the criteria of the First and Sixth Circuits are best adapted to the task.

1. If read literally, Section 532 and the parallel language of Section 535(c)(1) could be taken to demand that for the tax to apply, tax saving motives must be the sole purpose for an accumulation of earnings. Because human conduct is seldom motivated solely by a single impulse, such a construction would severely cripple the statute. Consequently, this interpretation was rejected by the court below. Record at 59. *See also* B. BITTKER & J. EUSTICE, *supra* at 216. Nevertheless, Section 532(a) uses the phrase "availed of for the

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[37] *See* S. REP. NO. 1622, *supra* n. 17, at 71-72.

purpose"; it does not provide that the tax will apply where the corporation was "availed of for a purpose" of tax saving. If Congress had desired to impose the tax if "one of the motives" for the accumulation was tax reduction, it certainly was capable of so providing. Similarly, petitioner notes[38] that Congress could also have provided, but did not that the tax would be applied where the corporation was "availed of principally for the purpose" or where it was "formed or availed of for the principal purpose" of tax saving. It is submitted, however, that use of the definite article "the" rather than the indefinite "a" which originally appeared in the evidentiary provision, supports respondent's position and the First Circuit in *Young Motor Co.* so held. *Cf., Malat v. Riddell*, 383 U.S. 569 (1966).

2. In support of its conclusion, the court below relied principally upon analogy to other instances in the tax law where motivation is the relevant consideration in determining the tax consequences of an individual's conduct, and where the degree or significance of the motivation factor is not detailed by the statute. Initially, as this Court has consistently held, in order for property transferred during a decedent's lifetime to be included in his taxable estate as a transfer "in contemplation of his death" under Section 2035, the death motive must be the dominant, controlling or impelling motive behind the transfer. In *Allen v. Trust Co. of Georgia*, 326 U.S. 630 (1946), the government argued that a transfer was in contemplation of death if motivated by a purpose to avoid the estate tax, as such a motive would cause a decedent to make an inter vivos transfer rather than a will. Thus, the government reasoned that the statute, which was intended to prevent evasion of the estate tax by inter vivos transfers, *United States v. Wells*, 283 U.S. 102, 112 (1931), is satisfied by mere presence of this consideration. The Court, however, rejected this simplistic ap-

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[38] Brief for Petitioner at 12-13.

proach. Every donor knows that property given away will not be included in his estate when he dies. 326 U.S. at 635. The estate tax saving through inter vivos transfers is readily apparent to any sophisticated donor and can be presumed at least to have entered his consideration. Nevertheless, this alone is not sufficient to excite application of Section 2035. Once the tax saving factor is introduced, a further analysis must be made to determine its significance upon the decision to make the transfer. Put in its statutory context, it is presumed that the dominant, controlling or impelling motive behind every transfer within three years prior to the date of death was estate tax saving, or another death-related factor, unless "shown to the contrary."

The court below also considered persuasive this Court's reasoning in *Commissioner v. Duberstein*, 363 U.S. 278 (1960). In *Duberstein*, the Court was called upon to set forth the circumstances under which a transfer of property is excludable from the gross income of the recipient as a gift, under the predecessor to Section 102(a). Recognizing that the ultimate issue was the intent with which the transfer was made, the Court held that the yardstick for determining whether a transfer is taxable as income, or nontaxable as a gift, is its basic motivation; the dominant reason explaining the transferor's action in making the transfer. Thus, in order to escape tax under Section 102(a) the taxpayer must prove that the dominant or basic motive for the transfer of property to him was the "detached and disinterested generosity" of the donor.[39]

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[39] Petitioner relies upon *Duberstein* for an entirely different reason. See Brief for Petitioner at 15. In its opinion the Court noted that

> The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since. The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to

Petitioner, on the other hand, would analogize to Section 7201, imposing criminal penalties upon attempts to evade or defeat the tax.[40] This section will apply if tax evasion motives play any part in affirmative conduct, the likely effect of which is to mislead or conceal. *Spies v. United States*, 317 U.S. 492, 499 (1943). *But see Marchetti v. United States*, 390 U.S. 39 (1968). While the tax of Section 531 is a "penalty" in the generic sense, and thus should be strictly construed, *see United Business Corp. supra* n. 24, because of their different purposes a basic distinction must always be maintained between criminal and civil penalties, *see Helvering v. Mitchell*, 303 U.S. 391, 404 (1938). Section 7201 contemplates government proof beyond a reasonable doubt of affirmative actions of misrepresentation or concealment, with the specific intent to evade tax; that is, knowledge and evil intent, a purpose to do wrong. *Holland v. United States*, 348 U.S. 121 (1948); *United States v. Murdock*, 290 U.S. 389 (1933). Section 7201 is, in the last analysis, aimed at conduct which, if permitted, would undermine the major source of revenue for the federal government.

Section 531, on the other hand, does not require that the government prove beyond a reasonable doubt that

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exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See Lockard v. Commissioner, 1 Cir., 166 F.2d 409.

363 U.S. 284. From this, petitioner concludes that the Sixth Circuit's consideration of the cases under Sections 2035 and 102 is immaterial. However, analysis of the passage as a whole, instead of the single sentence quoted by petitioner, indicates that the Court was addressing itself to the peculiar issue with which it was confronted, and was not laying down a dictum of general application in the tax field. This analysis is confirmed by the Court's reference to *Lockard v. Commissioner*, 166 F.2d 409 (1st Cir. 1948) in which the court held that merely because a transfer of property does not shift the onus of tax upon the income therefrom, this does not mean that it does not constitute a taxable gift; that is: the gift and income tax provisions of the Internal Revenue Code are not in *pari materia*.

[40] See Brief for Petitioner at 15 n. 10.

tax savings was the purpose for the accumulation. Rather, the statute places a most difficult burden on the taxpayer to establish the purpose of the accumulation. Unlike Section 7201, no affirmative act of concealment or misrepresentation is involved in a Section 531 case, since the information required to bring this provision into play is spread upon the tax returns, and readily available for examination. Nor is the element of evil purpose or wrongdoing involved in a Section 531 case. Finally, the conduct at which Section 531 is aimed is clearly dissimilar to that prescribed in Section 7201.

In attempting an analytical approach to the application of Section 532(a), the Fifth Circuit in *Barrow Mfg. Co. v. Commissioner, supra,* reasoned that the utility to the Section 533(a) presumption arising from an accumulation of earnings beyond the objectively reasonable needs of its business would be destroyed if "saddled with the requirement of proof of 'the primary or dominant purpose' of the accumulation." 294 F.2d at 82. See Brief for Petioner at 23-24. This analysis completely misconstrues the effect of Section 533(a). The evidentiary and taxing sections clearly are conterminous, so that taxpayer would be called upon to convince the trier of fact that the dominant, controlling or impelling motive behind an "excess" accumulation was not the avoidance of tax upon its shareholders.

4. Although a person's activities are seldom the result of a single purpose or motivating impulse, generally there will be some one factor which tips the balance in favor of one alternative and against the other, or without which a particular decision would not be made. *Cf., Commissioner v. Duberstein, supra* (basic reason). By establishing a standard in terms of a search for the dominant, controlling or impelling motive behind a decision to accumulate the court below has effected a reasonable compromise between the conflicting policies inherent in the application of Section 531; the production of revenue through the distribution of taxable dividends on the one hand, and on the

other the protection and stimulation of competition in the marketplace.

The first tax on accumulated earnings, enacted at a time when corporate earnings were not taxed, was aimed at preventing the total avoidance of federal income taxes upon corporate earnings. While the tax is not productive of substantial revenues,[41] it is likely that the threat of its imposition has caused payment of dividends which otherwise would not have been declared. Due to the present high rate of tax upon corporate earnings, however, the safeguard against tax avoidance found in Section 531, while of continuing necessity,[42] is no longer of the same crucial importance in terms of federal revenues.

Contemporary economics would recognize a distinction between a corporation's savings (bank accounts and marketable securities) which do not increase the flow of spendable income and thus stimulate buying, and investments (principally inventory and fixed assets) which do make economic contribution through the creation of jobs.[43] Thus, the continued virility of the Section 531 tax can be partially justified as a deterrent to corporate saving and as an inducement to corporate expansion and, in fact, empirical studies have shown that the tax does have this effect.[44]

It appears to be generally accepted that, to an appreciable extent, the Section 531 tax stimulates the acquisition of small businesses by larger ones. *See, e.g.*, S. SURREY & W. WARREN, FEDERAL INCOME TAXATION, 1405 (1962). The constant threat of a Section 531 deficiency and the expenditure of time and effort involved in defending against the

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[41] JOINT COMMITTEE at 109, 154-56.

[42] S. REP. NO. 1622, *supra* n. 17, at 68.

[43] An excess of saving over investment is credited as a primary cause of the great depression of 1929. A. HANSEN, BUSINESS CYCLES AND NATIONAL INCOME, Ch. 5, and at 334-43 (2d ed. 1964); R. PAUL, TAXATION IN THE UNITED STATES 266-84 (1954).

[44] JOINT COMMITTEE at 36.

challenge under Section 531 are important factors inducing successful closely held corporations to sell to or merge with public corporations. Although the 1954 amendments were intended to provide relief in this area, the substantial volume of accumulated earnings tax cases,[45] and this Court's consideration of the question at issue, combined with the current merger spiral, testify eloquently to the continuing pressures exerted by Section 531 upon closely-held businesses. The Section 531 tax, then, should be construed in a manner which does not do violence to the principles of competition and which is consistent with its basic economic purposes. As the Second Circuit noted in *Electric Regulator Corp. v. Commissioner*, 336 F.2d 339, 346 (2d Cir. 1964), Congress' desire to prevent abuse through the use of private or closely-held family-owned corporations must be balanced with its desire to stimulate and encourage the economic growth of the smaller units of industry.

Ultimately, the different criteria heretofore enunciated under Section 532(a) relate to the extent of the taxpayer's burden of proof. If taxpayer must prove that tax motives were not present or played no part in its decision to accumulate earnings, as a practical matter the subjective element has been eliminated from the statute and taxpayer is limited to definite and fixed commitments. Thus prejudiced is the taxpayer which in good faith desires, for example, to expand its business, either internally or through acquisition, in related or unrelated areas, but which has not formulated sufficiently definite plans or has not, when the revenue agent comes in on audit, proceeded to such an extent that credit is permitted under Section 535(c) (1).[46]

This situation is most common in closely held businesses which are considering an expansion or diversification plan and which cannot move precipitously in view of the fact that an erroneous business decision would place the en-

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[45] *See* Petitioner's Brief for Certiorari at 8.

[46] *See generally Bremerton Sun Publ. Co., supra* n. 29.

tire business in financial jeopardy. In the usual situation, the closely held corporation is unlikely to proceed until it has achieved a strong and sound financial condition permitting it to survive reverses occasioned by its decision to expand or diversify. Further, because of its inexperience in the field of expansion and diversification, the closely held corporation tends to be more cautious, and accordingly, takes longer to effect an expansion program or consummate an acquisition. The net effect of the government's position would require the taxpayer to enter into expansion or acquisition plans prematurely and subject itself to the attendant risks, or face the Hobson's choice of paying the Section 531 tax or paying dividends.

Petitioner complains that the Sixth Circuit's standard would tend to result in self-serving declarations unsupported by objective evidence or supported only by "carefully assembled" documentation. See Brief for Petitioner at 22. However, this is not an infirmity of the legal standard but is a question of the sufficiency of the evidence. When earnings exceed definite and certain business needs, the trier of fact would be justifiably cynical and suspicious of unsupported allegations of non-tax motives. To prove the negative, taxpayer would be called upon to establish a solid and substantial reason; in fact, the dominant, controlling or impelling motive for the failure to distribute "excess" earnings to its shareholders.

Finally, it must be recognized that the surtax penalty is applicable on a year-to-year basis. Accordingly, a taxpayer claiming that the principal, dominant or controlling reason for an accumulation is not for the avoidance of tax to its shareholders must be prepared to live with the reasons advanced in future years and the assumptions or reasons given must stand the test of credibility when compared with events materializing in future years. To the extent that a taxpayer's reasons are not substantiated by such events, its credibility is impaired and motives impuned. Accordingly, the "subjective test" provides little comfort to

the taxpayer unless its reasons for the accumulation are completely candid, reasonable in their context, and consistent with future conduct.

Petitioner's position herein is most difficult to comprehend. For not only is its argument inconsistent with this Court's decision in *Chicago Stock Yards Co., supra*, and the statutory scheme of the unreasonable accumulation provisions, but it is also at variance with its economic policies which favor competition and the promotion of the growth of smaller businesses. It should be absolutely clear that if the government's position is sustained in this case, the future growth and development of smaller businesses will be severely limited. We believe that such a result is neither provided for nor intended by the unreasonable accumulation provisions of the Internal Revenue Code.

CONCLUSION

The judgment of the United States Court of Appeals for the Sixth Circuit should be affirmed in all respects.

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